MARTIN INVESTMENT MANAGEMENT, LLC
1560 SHERMAN AVENUE SUITE 1250
EVANSTON, ILLINOIS 60201

(847) 424-9124
FAX (847) 424-9182

October 2022

Investing in a New Playing Field
The Macro Market

In the third quarter of 2022, the S&P 500 Index had a total return of -4.88%. For the same period, the MSCI EAFE Index (USD) Net had a total return of -9.36% while the MSCI World Index (USD) Net had a total return of -6.19%. The market choppiness has continued, as investors digest the prospects of additional tightening, slower growth, and lowered earnings guidance. The ongoing transition in the economy and markets is likely to be volatile. Recession risk is growing as central banks focus on combating inflation through higher rates, which slows economic growth. The current and complex environment of rising inflation and slowing growth is meaningfully affecting all financial assets by deflating equities, bonds, real estate, and other investments. Because price inflation is not one size, the global economy is both more interconnected and more fragmented than ever. Central banks' responses will vary because their inflationary situations vary.[1]

The top-down macro news is dismal given the concurrent concerns about inflation and slowing growth. Investors are being presented with a very volatile macro driven investment landscape. Dan Clifton of Strategas Partners believes that the aftershocks from the 2020 events look "eerily similar" to the 1970s following the 1968/1969 events.[2] The similarities exist in GDP, CPI, energy, supply chains, tax, price controls, and divisive politics. The S&P 500 is trading almost identically in 2022 as it was in 1970 and as in 1974 as inflation remains elevated. Stocks do not rally with inflation increasing. Inflation has been a result of bottlenecks in products, transportation, labor, and energy. While there has been some resolution to the bottlenecks in products and transportation, labor dislocation and energy source constraints continue to be problematic for world economies.[3]

About $5.7 trillion of federal fiscal aid was enacted since the start of Covid-19 on top of the $5 trillion of the Federal Reserve's balance sheet. The response to assist the U.S. consumer during the pandemic exceeded the necessary response to correct the economic downturn, releasing too much money into the system. With a disbursement gap of 17.6%, the government spending and transfers increased sharply relative to pre-Covid-19 trends. Countries, such as the U.S., with larger stimulus packages tended to experience greater inflation acceleration. The size of the inflationary acceleration is negatively correlated to the unemployment gap, suggesting that differences in labor market slack account for a significant part of the cross-country variation in inflation acceleration.[4]

Mr. Powell said "the longer inflation remains well above target, the greater the risk the public does begin to see higher inflation as the norm and that has the capacity to really raise the costs of getting inflation down."[5] The Feds have raised rates this year at the fastest clip since the early 1980s, taking the benchmark federal funds rate from near zero in March 2022 to a range of 3.0% to 3.25% in September 2022. While the Fed has only just started to reduce its balance sheet mostly through treasuries and mortgage-backed securities, it is committed to raise rates until the Fed Funds rate is above the inflation rate. The balance sheet reduction will remove liquidity from the financial system, and in time, the Federal Reserve hopes that a reduced money supply would lower demand and push prices down. While accomplishing this task, the Fed hopes to avoid a hard landing, causing a recession and increased unemployment. With a current 11 million job openings and only 6 million unemployed, the Fed hopes to destroy openings but not the employed.[6]

The Fed's current task is not just to stabilize the inflation rate, as in 1994, but to bring it down substantially, as in 1980, which is difficult even without food and energy shocks.[7] Although there has been some relief from falling energy costs and improved supply chains, the upward pressures of everything else will make slowing inflation difficult to achieve at 3.1%.[8] On the positive side, the U.S. has emerged relatively strong from the pandemic compared to China with Covid-19 lockdowns and Europe with the Ukrainian war. The U.S. is very important in the inflation story for the whole world. Commodities of food and oil are usually priced in U.S. dollars (USD). Due to the recent depreciation of most global currencies to the USD, many countries are facing increased commodity pressures. The U.S. economy has largely escaped the worst of these ills, but a rising dollar is punishing the rest of the world at a time when price increases in many places are already outpacing incomes. Central banks around the world have moved to combat the effects of a soaring dollar and rising inflation, joining the Federal Reserve in risking a recession to rein in climbing prices.[9]

Because of Russia and China challenging the current world order, more countries are increasing their domestic production and infrastructure as de-globalization is taking place. Investors are flocking to the U.S, as economic and geopolitical tensions flare up.
Europe's economy is slowing more than the U.S., by having to fight inflation while supporting the peripheral countries, especially Italy, and confronting geopolitical risks from the Ukrainian war. Since the unemployment rate has been historically higher in Europe than the U.S., economists see few signs that the eurozone economy is overheating.

Instead, eurozone inflation is being driven primarily by soaring energy prices and persistent supply bottlenecks, which the ECB can do little to solve.[10] In a fight to stimulate growth, the U.K.'s new administration has introduced pro-growth policies through lower taxation, which is juxtaposed to the Bank of England's tightening to fight inflation and extensive fiscal support to assist its populace. No one is certain how this will end running high deficits, lowering taxes, and tightening monetary policy. In Canada, New Zealand, and Australia central banks have increased rates, not only to address their currencies but also to fight their financial bubble in real estate. The Bank of Japan left its policy rate at its previous low level and took other steps to ease the growing inflation pressure by intervening in currency markets to sell dollars and buy the yen.[11] Across the rest of Asia, export growth is weakening in the region's major trading economies, a sign of declining demand for electronics as Western appetite for consumer goods fades. Chinese export growth slowed in August from 18% to 7.1% from continued lockdowns.[12]

While consumers focus on energy prices, less attention is given to the restructuring of energy markets. Simply getting the higher priced energy resources to where they are needed requires many changes. Stable inflation will require that the developed world economies restructure their facilities. Eliminating dependency on Russian natural gas in Europe is very difficult because alternate pipeline sources do not exist. In the meantime, importing natural gas from the U.S. and other places via tankers is challenging as ships require converting natural gas into liquefied natural gas (LNG) and then to a "regasification" process when unloaded. All this takes expensive, specialized facilities that the *Financial Times* points out will become "stranded assets" if Europe later moves away from fossil fuel use before the costs can be recovered.[13] Even parts of New England are having trouble securing natural gas for electricity after retiring their coal, oil, and nuclear plants, competing with Europe and Asia for non-U.S. cargoes. Because of the Jones Act, no LNG from other parts of the U.S. can be transported as U.S. flagged tankers do not exist.[14]

U.S. equity markets underperformed the global benchmark by 10% from 2000 to 2008. Since the Great Financial Crisis (GFC), tepid economic growth led central banks to persist with near zero interest rates and further monetary stimulus, driving bond yields to all-time lows. The U.S. has outperformed global benchmarks by about 170% since the GFC. During this time, many companies, particularly in the U.S. have been hugely successful in creating giant monopolies. From 2008 to 2022, the sector composition of Technology played a significant role in driving U.S. superior performance[15] The U.S. outperformance relative to global markets may be more difficult going forward. Past tailwinds for equities of low interest rates, technological disruptions, and easy global trade are dissipating and being replaced by high inflation, aggressive monetary tightening, higher bond yields, increased taxation, and de-globalization. A company's approach and ability to perform in this different type of economic environment will vary, but short-term disruption, controversy, or setback in the market can cause mispricing. With stock prices oscillating more than their underlying fundamentals, opportunities can be created. Researching and understanding individual companies and their challenges become even more important.[16]

Over the past thirty years, some of the most valuable companies have been found in industries that derive their value from intangible assets. Intangible assets include brands, culture, patents, research and development. Companies, that invest heavily in intangible assets and succeed in creating a large customer base of product portfolios, benefit from exceptional profitability on incremental sales. These companies have had high returns on incremental capital and significant growth opportunities dramatically changing their intrinsic value for investors. Because intangible assets are typically expensed rather than capitalized, reported earnings and book value are depressed. Historical accounting data is immaterial to valuing companies with intangible assets as growth prospects, changes in strategy, and the duration of the competitive advantage, are assessed. We believe that investors who are overly focused on reported earnings and book value may be missing opportunities to buy similar cash flow streams at attractive relative prices, despite price/earnings and price/book ratios looking expensive. With equity investing, the challenge is always estimating the timing and the magnitude of expected cash flows over the life of an investment.[17]

When it comes to investing in the equity market, intelligent investing implies investing for specific objectives. Martin Investment Management, LLC has two objectives for its investments, capital preservation and wealth creation. We believe the best way to deliver strong long-term performance is to build an equity portfolio of reasonably valued stocks issued by leading companies in their respective industries. These companies are generally able to gain market share over time and enjoy higher margins than their competitors. We look for persistent and durable earnings, so that the investment can be held for long-term capital appreciation, thereby, improving tax efficiency. We also look for companies that benefit from secular tailwinds, selling products and services in sectors of the economy that are undergoing structural growth.[18]

The nature of the present uncertainty and the recent equity pullback in the market make a better environment from which to select stocks even while investors are moving through a sticky part of the economic and equity cycles. We believe that stock-specific opportunities for investors have broadened. With an increasing recognition that the investment landscape has changed, not least the deflationary mindset and low risk premium, we are looking forward to the future.

Our thoughts for a colorful and calming fall season!

Note:

1. Mauldin, John. "Your Inflation May Vary", *Advisor Perspectives*, September 27, 2022.
2. Clifton, Daniel. "Aftershocks of 2020: The Midterm Elections Meet De-Globalization", *Strategas Research Partners*, September 23, 2022.
3. Rissmiller. Donald J. "Economic Outlook", *Strategas Research Partners*, September 22, 2022.
4. Mauldin, John. "Your Inflation May Vary", *Advisor Perspectives*, August 27, 2022.
5. Timaraos, Nick. "Powell Affirms Fed Will Target Inflation", *Wall Street Journal*, September 9, 2022.
6. Rissmiller. Donald J. and Brandon Fontaine. "Still Watching for Monetary Policy To Hit the U.S. Labor Market", *Strategas Research Partners*, September 12, 2022.
7. Blinder, Allen S. "Lowering Inflation While Avoiding Recession", *Wall Street Journal*, September 27, 2022.
8. Ip, Greg. "Markets Now Brace for a Hard Landing", *Wall Street Journal*, September 23, 2022.
9. Fairless, Tom and Douglas, Jason. "Stocks Slump as Economies Reel", *Wall Street Journal*, September 24, 2022.
10. Fairless, Tom, "ECB Delivers Largest Rate Rise in 23 Years, *Wall Street Journal*, September 9, 2022.
11. Horner, Will and Megumi Fujikawa. "Central Banks Scramble to Raise Rates", *Wall Street Journal*, September 23, 2022.
12. Fairless, Tom and Jason Douglas. "Stocks Slump as Economies Reel", *Wall Street Journal*, September 24, 2022.
13. Livsey, Alan. "Emergency rush into gas prompts question of stranded energy assets", *Financial Times*, September 19, 2022.
14. Mauldin, John. "Notes on Inflation", *Advisor Perspectives*, September 23, 2022.
15. Global Investment Strategy. *BCA Research*, September 23, 2022.
16. McQueen, Colin. "Playing Field Is Now More Even for Value" T. Row Price Insights, September 1, 2022.
17. Hargis, Kent and Sammy Suzuki. "Turning Less into More: Revisiting Equity Risk In a Volatile Year", *Advisor Perspective*, September 12, 2022.
18. Global Investment Strategy. *BCA Research*, September 23, 2022.

Note: